Executive Summary

President George W. Bush created the President's Advisory Panel on Federal Tax Reform in January 2005. The President instructed the Panel to recommend options that would make the tax code simpler, fairer, and more conducive to economic growth.

Since then, the Panel has analyzed the current federal income tax system and considered a number of proposals to reform it. During the course of the Panel's work, some themes emerged that guided its deliberations:

- We have lost sight of the fact that the fundamental purpose of our tax system is to raise revenues to fund government.
- Tax provisions favoring one activity over another or providing targeted tax benefits to a limited number of taxpayers create complexity and instability, impose large compliance costs, and can lead to an inefficient use of resources. A rational system would favor a broad tax base, providing special treatment only where it can be persuasively demonstrated that the effect of a deduction, exclusion, or credit justifies higher taxes paid by all taxpayers.
- The current tax system distorts the economic decisions of families and businesses, leading to an inefficient allocation of resources and hindering economic growth.
- The complexity of our tax code breeds a perception of unfairness and creates opportunities for manipulation of the rules to reduce tax. The profound lack of transparency means that individuals and businesses cannot easily understand their own tax obligations or be confident that others are paying their fair share.
- The tax system is both unstable and unpredictable. Frequent changes in the tax code, which often add to or undo previous policies, as well as the enactment of temporary provisions, result in uncertainty for businesses and families. This volatility is harmful to the economy and creates additional compliance costs.
- The objectives of simplicity, fairness, and economic growth are interrelated and, at times, may be at odds with each other. Policymakers routinely make choices among these competing objectives, and, in the end, simplification is almost always sacrificed. Although these objectives are often in tension, meaningful reform can deliver a system that is simpler, fairer, and more growth-oriented than our existing tax code.

With these themes in mind, the Panel evaluated a number of reform proposals to find out whether they would meet the President's goals for current and future generations of Americans. After 12 public meetings in five states and Washington D.C., the Panel reached consensus to recommend two tax reform plans. The Panel's recommended plans, labeled the Simplified Income Tax Plan and the Growth and Investment Tax Plan, include the following major features:

- Simplification of the entire tax system and streamlined tax filing for both families and businesses.
- Lower tax rates on families and businesses, while retaining the progressive nature of our current tax system.
- Extension of important tax benefits for home ownership and charitable giving to all taxpayers, not just the 35 percent who itemize; extension of tax-free health insurance to all taxpayers, not just those who receive insurance from their employers.
- Removal of impediments to saving and investment.
- Elimination of the Alternative Minimum Tax, which is projected to raise the taxes of more than 21 million taxpayers in 2006 and 52 million taxpayers by 2015.

The two plans differ in the taxation of businesses and capital income. Although they use different approaches, the plans share a common goal of providing simple and straightforward ways for Americans to save free of tax and lower the tax burden on productivity-enhancing investment by businesses.

A table outlining both tax reform plans follows this summary.

The Panel also developed and considered a progressive consumption tax plan that would be administered using the infrastructure of our familiar tax system, but was unable to reach a consensus to include it as a recommendation. The Panel also considered ideas for a value-added tax and a national retail sales tax, and decided not to recommend either approach.

The Simplified Income Tax Plan and the Growth and Investment Tax Plan put forward by the Panel achieve the goals set by the President in a number of ways.

They reduce complexity by:

- Allowing every taxpayer to use a simple tax form, which is less than half the length of the current Form 1040.
- Combining 15 different tax provisions for at-work saving, health saving, education saving, and retirement saving into three simple saving plans.
- Eliminating a complicated set of phase-outs that leave taxpayers wondering whether they are eligible to benefit from numerous provisions.
- Replacing a confusing, full-page worksheet for seniors reporting Social Security income with a simple computation that is no more than six lines.
- Replacing the complicated rules for small business with a system that is based on the records their owners already keep.

They improve fairness by:

- Ensuring that tax benefits are easily understood and accessible, thereby increasing confidence in the tax system.
- Making most tax benefits available to all taxpayers, not just the 35 percent who itemize.
- Shifting some tax preferences from deductions, which tend to benefit high-income households, to tax credits, which benefit all taxpayers equally.
- Reducing marriage penalties by ensuring that the rate brackets, the Family Credit, and the taxation of Social Security benefits for married couples are twice the amounts for singles.
- Transforming the earned income tax credit and savers credit into provisions that are more accessible and beneficial to low income taxpayers.
- Closing loopholes and eliminating special tax breaks that allow the well-advised to avoid paying their fair share.
- Maintaining the progressive nature of our tax system.

They promote economic growth by:

- Reducing the double-tax on corporate profits earned in the United States.
- Promoting savings throughout our economy, especially at the household level.
- Equalizing the tax treatment of several forms of corporate financing, raising the incentives for companies to issue equity rather than debt to finance growth.
- Reducing the likelihood that households or businesses will alter economic behavior because of special tax preferences or benefits.
- Lowering the top marginal rates on individuals and businesses.
- Reducing the paperwork burden for small businesses, and providing them an immediate write-off for all purchases of new tools and equipment.
- Updating our international tax system.

These benefits will follow only from a fundamental reform of the tax code. In isolation, some of the recommended pieces may be controversial, but taken as a whole, they accomplish the Panel's objectives. Each plan is designed to be comprehensive and should be viewed as an integrated package. The Panel believes that without large-scale changes, and continued commitment to avoiding complexity and special tax breaks, the tax code will become even more confusing, unfair, and damaging to our economy. We urge the Administration and Congress to consider these recommendations carefully and to move forward with reform.

The Current Tax System	
Provisions	**Current Law (2005)**
Households and Families	
Tax rates	Six tax brackets: 10%, 15%, 25%, 28%, 33%, 35%
Alternative Minimum Tax	Affects 21 million taxpayers in 2006; 52 million taxpayers in 2015
Personal exemption	$3,200 deduction for each member of a household; phases out with income
Standard deduction	$10,000 deduction for married couples filing jointly, $5,000 deduction for singles, $7,300 deduction for heads of households; limited to taxpayers who do not itemize
Child tax credit	$1,000 credit per child; phases out for married couples between $110,000 and $130,000
Earned income tax credit	Provides lower-income taxpayers refundable credit designed to encourage work. Maximum credit for working family with one child is $2,747; with two or more children is $4,536
Marriage penalty	Raises the tax liability of two-earner married couples compared to two unmarried individuals earning the same amounts
Other Major Credits and Deductions	
Home mortgage interest	Deduction available only to itemizers for interest up to $1.1 million of mortgage debt
Charitable giving	Deduction available only to itemizers
Health insurance	Grants tax-free status to an unlimited amount of premiums paid by employers or the self-employed
State and local taxes	Deduction available only to itemizers; not deductible under the AMT
Education	HOPE Credit, Lifetime Learning Credit, tuition deduction, student loan interest deduction; all phase out with income
Individual Savings and Retirement	
Defined contribution plans	Available through 401(k), 403(b), 457, and other employer plans
Defined benefit plans	Pension contributions by employers are untaxed
Retirement savings plans	IRAs, Roth IRAs, spousal IRAs – subject to contribution and income limits
Education savings plans	Section 529 and Coverdell accounts
Health savings plans	MSAs, HSAs, and Flexible Spending Arrangements
Dividends received	Taxed at 15% or less (ordinary rates after 2008)
Capital gains received	Taxed at 15% or less (higher rates after 2008)
Interest received (other than tax-exempt municipal bonds)	Taxed at ordinary income tax rates
Social Security benefits	Taxed at three different levels, depending on outside income; marriage penalty applies
Small Business	
Tax rates	Typically taxed at individual rates
Recordkeeping	Numerous specialized tax accounting rules for items of income and deductions
Investment	Accelerated depreciation; special small business expensing rules allow write-off of $102,000 in 2005 (but cut by ¾ in 2008)
Large Business	
Tax rates	Eight brackets: 15%, 25%, 34%, 39%, 34%, 35%, 38%, 35%
Investment	Accelerated depreciation under antiquated rules
Interest paid	Deductible
Interest received	Taxable (except for tax-exempt bonds)
International tax system	Worldwide system with deferral of business profits and foreign tax credits
Corporate AMT	Applies second tax system to business income

How the Tax Code Would Change		
Provisions	**Simplified Income Tax Plan**	**Growth and Investment Tax Plan**
Households and Families		
Tax rates	Four tax brackets: 15%, 25%, 30%, 33%	Three tax brackets: 15%, 25%, 30%
Alternative Minimum Tax	Repealed	
Personal exemption	Replaced with Family Credit available to all taxpayers: $3,300 credit for married couples, $2,800 credit for unmarried taxpayers with child, $1,650 credit for unmarried taxpayers, $1,150 credit for dependent taxpayers; additional $1,500 credit for each child and $500 credit for each other dependent	
Standard deduction		
Child tax credit		
Earned income tax credit	Replaced with Work Credit (and coordinated with the Family Credit); maximum credit for working family with one child is $3,570; with two or more children is $5,800	
Marriage penalty	Reduced; tax brackets and most other tax parameters for couples are double those of individuals	
Other Major Credits and Deductions		
Home mortgage interest	Home Credit equal to 15% of mortgage interest paid; available to all taxpayers; mortgage limited to average regional price of housing (limits ranging from about $227,000 to $412,000)	
Charitable giving	Deduction available to all taxpayers (who give more than 1% of income); rules to address valuation abuses	
Health insurance	All taxpayers may purchase health insurance with pre-tax dollars, up to the amount of the average premium (estimated to be $5,000 for an individual and $11,500 for a family)	
State and local taxes	Not deductible	
Education	Taxpayers can claim Family Credit for some full-time students; simplified savings plans	
Individual Savings and Retirement		
Defined contribution plans	Consolidated into Save at Work plans that have simple rules and use current-law 401(k) contribution limits; AutoSave features point workers in a pro-saving direction (Growth and Investment Tax Plan would make Save at Work accounts "prepaid" or Roth-syle)	
Defined benefit plans	No change	
Retirement savings plans	Replaced with Save for Retirement accounts ($10,000 annual limit) available to all taxpayers	
Education savings plans	Replaced with Save for Family accounts ($10,000 annual limit); would cover education, medical, new home costs, and retirement saving needs; available to all taxpayers; refundable Saver's Credit available to low-income taxpayers	
Health savings plans		
Dividends received	Exclude 100% of dividends of U.S. companies paid out of domestic earnings	Taxed at 15% rate
Capital gains received	Exclude 75% of corporate capital gains from U.S. companies (tax rate would vary from 3.75% to 8.25%)	Taxed at 15% rate
Interest received (other than tax exempt municipal bonds)	Taxed at regular income tax rates	Taxed at 15% rate
Social Security benefits	Replaces three-tiered structure with a simple deduction. Married taxpayers with less than $44,000 in income ($22,000 if single) pay no tax on Social Security benefits; fixes marriage penalty; indexed for inflation	
Small Business		
Tax rates	Taxed at individual rates (top rate has been lowered to 33%)	Sole proprietorships taxed at individual rates (top rate lowered to 30%); Other small businesses taxed at 30%
Recordkeeping	Simplified cash-basis accounting	Business cash flow tax
Investment	Expensing (exception for land and buildings under the Simplified Income Tax Plan)	
Large Business		
Tax rates	31.5%	30%
Investment	Simplified accelerated depreciation	Expensing for all new investment
Interest paid	No change	Not deductible (except for financial institutions)
Interest received	Taxable	Not taxable (except for financial institutions)
International tax system	Territorial tax system	Destination-basis (border tax adjustments)
Corporate AMT	Repealed	